

Q. When the FCC references the need to provide "meaningful access" as intended by Congress, how should the Commission evaluate this guidance?

A. The FCC prefaced its discussion concerning the importance of Section 271 with a clear understanding that the competitive checklist embodied <u>additional</u> obligations that were particular to the RBOCs because of their unique market position and the threat that position posed to interexchange competition:

> Section 251, by its own terms, applies to *all* incumbent LECs, and section 271 applies only to BOCs, a subset of incumbent LECs. In fact, section 271 places specific requirements on BOCs that were not listed in section 251. These additional requirements reflect Congress' concern, repeatedly recognized by the Commission and courts, with balancing the BOCs' entry into the long distance market with increased presence of competitors in the local market. Before the 1996 Act's passage, the BOCs, the local progeny of the once-integrated Bell system, were barred by the terms of the MFJ from entering certain lines of business, including providing interLATA services. The ban on BOC provision of long distance services was based on the MFJ court's determination that such a restriction was "clearly necessary to preserve free competition in the interexchange market." The protection of the interexchange market is reflected in the fact that section 271 primarily places in each BOC's hands the ability to determine if and when it will enter the long distance market. If the BOC is unwilling to open its local telecommunications markets to competition or apply for relief, the interexchange market remains protected because the BOC will not receive section 271 authorization.... Section 271 was written for the very purpose of establishing specific conditions of entry into the long distance that are unique to the BOCs. As such, BOC obligations under section 271 are not necessarily relieved based on any determination we make under the section 251 unbundling analysis.[23]

[23] *TRO*, ¶ 655 (footnotes omitted).

The obligations of Section 271 are intended to do more than passively open the local market – these provisions are additional specific obligations intended to offset, as best they can, the formidable advantages that BellSouth was expected to enjoy once it was authorized to provide long distance service. The absence of meaningful Section 271 access is clear – BellSouth's penetration of the consumer and small business market is approximately 60%, while BellSouth obliquely describes market conditions as exhibiting "pricing discipline and stable churn" (i.e., its prices are holding steady and it seeing less competition).[24] In contrast, BellSouth's wholesale lines have fallen by more than 400,000 in the last six months alone, with most of the reduction in the residential and small business markets.[25]

B. The Recommended Methodology

Q. Based on your collective understanding of prior FCC orders and the stated purpose of the competitive checklist of Section 271, what do you believe is the appropriate methodology to set "just and reasonable" rates for Section 271 network elements?

24 BellSouth Investor News, January 25, 2006, page 8.

25 BellSouth Quarterly Investor Updates, 2Q05 and 4Q05.

A. I believe that there is no question that the basic just and reasonable rate standard that has historically been applied in state and federal statutes is a cost-based pricing standard. Although the standard has its roots in embedded cost analysis, there is general agreement that it is more properly applied using a measure of forward-looking costs,[26] to which should be added a reasonable allocation of overhead.

Q. Doesn't this approach produce rates that are the equivalent of TELRIC?

A. No. I recognize that the FCC has determined that §271 elements need not be strictly offered at TELRIC-based rates, [27] but that does not mean that BellSouth may charge whatever price that it wants (which is the same as saying "what the market will bear"). The fact is that TELRIC-based rates themselves must also fall

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[26] Although I recognize that BellSouth will claim that its Section 271 prices should not be judged against any cost measure preferring, as one would expect from a monopolist, that it be permitted to price "what the market will bear," it has sponsored affidavits that generally explain the superiority of forward looking costs to the use of historical costs. *See*, for instance, Declaration of Aniruddha Banerjee on behalf of BellSouth, extolling the virtues of incremental costing, which he describes as superior "for efficient and fair pricing, especially in competitive settings." Federal Communications Commission File No. EB-05-MD-029 (Momentum 271 Complaint), ¶ 8.

[27] *See*, for instance, *TRO* ¶ 659:

> So if, for example, pursuant to section 251, competitive entrants are found not to be "impaired" without access to unbundled switching at TELRIC rates, the question becomes whether BOCs are required to provide unbundled switching at TELRIC rates pursuant to section 271(c)(2)(B)(vi). In order to read the provisions so as not to create a conflict, we conclude that section 271 requires BOCs to provide unbundled access to elements not required to be unbundled under section 251, but does not require TELRIC pricing.

within the range of just and reasonable rates.[28] Consequently, while BellSouth is not necessarily *required* to charge TELRIC-based rates for Section 271 network elements, the difference between the TELRIC rate and the Section 271 rate should not be substantial as *both* must fall within the range of just and reasonable results.

Second, it is important to understand that the FCC's TELRIC rules for switching and transport (which form the vast majority of the Section 271 elements at issue in this proceeding) are free from the controversy that frequently surrounds how loop-costs are calculated.[29] For instance, although an optimized (sometimes called hypothetical) network design is used to determine loop costs, the

[28] Specifically, section 252(d) PRICING STANDARDS requires:

(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES-

Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and <u>the just and reasonable rate for network elements</u> for purposes of subsection (c)(3) of such section—

(A) shall be—

(i) based on the cost (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

(ii) nondiscriminatory, and

(B) may include a reasonable profit.

[29] 47 C.F.R § 51.505. Although the Commission's TELRIC standard includes the label "incremental," the standard is more properly viewed as a total *average* cost calculation because it calculates the total cost of an element divided by total demand. Its "incremental" designation does not mean that it is the cost to produce an incremental unit of output, but is instead used to mean that the cost of one element should not include costs incurred to supply other elements (*i.e.*, they are the costs incremental to the element being measured). As such, the TELRIC standard is intend to fully compensate and incumbent for its network-element related costs, albeit its forward looking (not embedded) costs.

Commission's TELRIC rules require that BellSouth's actual switch locations (i.e., wire centers) be used in the cost analysis, defining both the switching topology and transport routes by actual network locations. In addition, BellSouth has deployed the digital switching and fiber optic technology assumed by a TELRIC analysis, thereby eliminating this distinction between "forward looking" and "actual" costs.

BellSouth itself has testified that its concerns with the FCC's TELRIC methodology do not apply to switching and transport network elements:

> … it is the additional constraints currently mandated by the FCC that the incumbent local exchange carriers ("ILECs") object to with respect to TELRIC-based rates. The use of a hypothetical network and most efficient, least-cost provider requirements have distorted the TELRIC results and normally understate the true forward-looking costs of the ILEC.
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> These distortions, however, are most evident in the calculation of unbundled <u>loop</u> elements, and they are less evident in the switching and transport network elements that make up switched access. In fact, if BellSouth had conducted a TSLRIC study for switched access, the underlying assumptions with respect to forward-looking equipment and architectures would have been consistent with those used in the TELRIC studies for switching and transport UNEs.[30]

[30] Testimony of Robert McKnight on behalf of BellSouth, Public Service Commission of South Carolina, Docket No. 1997-239-C at 7-8 (Dec. 31, 2003) ("McKnight Testimony"). Emphasis added.

Moreover, BellSouth has explained that a rate is compensatory if it covers it TSLRIC, which is *less* than TELRIC.[31] Thus, a TELRIC-based rate covers its costs and provides contribution to shared and common costs as well:

> Since TSLRIC reflects all of the direct costs … TSLRIC studies are the basis of testing for cross-subsidization. If rates for a service exceed the service's TSLRIC …, then the service is not being subsidized by other services.[32]
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> ***
>
> … all else being held constant, the allowance of shared and common costs under the TELRIC cost methodology increases costs above those that would have been obtained from a comparable TSLRIC switched access study.[33]

As the above explains, using TELRIC to estimate the direct cost of an element should be relatively non-controversial. Properly implemented, the method computes an average total cost that fully compensates BellSouth for the forward looking costs or providing network facilities; moreover, for transport and switching, FCC rules do not optimize the network, but instead require that actual wire center locations and generally model technologies – fiber and digital

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[31] I note that the FCC has recognized that the TSLRIC methodology is an acceptable method to establish direct costs:

> TELRIC is the specific forward-looking methodology described in 47 C.F.R. § 51.505 and required by our rules for use by states in determining UNE prices. States often use "total service long run incremental cost" (TSLRIC) methodology in setting rates for intrastate services. It is consistent with the *Local Competition Order* for a state to use its accustomed TSLRIC methodology (or another forward-looking methodology) to develop the direct costs of payphone line service costs.

Payphone Order, ¶ 49 (footnotes omitted).

[32] McKnight Testimony, at 6.

[33] McKnight Testimony, at 8.

switching – that have actually been implemented in the network. Consequently, TELRIC-based estimates of direct costs are an appropriate starting point to establish Section 271 prices.

Q. What steps do you recommend the Commission employ to establish the recurring rates for Section 271 network elements?

A. As explained above, the basic approach to determining just and reasonable rates is to determine the direct costs and add "a just and reasonable portion of the carrier's overhead costs."[34] TELRIC-compliant prices are within the just and reasonable range, but do not necessarily identify the upper end of that range. Because Section 271 prices may be higher than TELRIC, I recommend that the Commission establish just and reasonable 271 prices in this proceeding through a two step process.

* First, for purposes of establishing Section 271 rates (and only Section 271 rates), I recommend the Commission use the forward looking prices that BellSouth proposed in Docket No. 14361-U as the direct cost for each element. The Commission has already concluded that these prices are not TELRIC compliant for, among other reasons, the fact that BellSouth's cost of capital (and other input assumptions) were inappropriate. By using these rates as an estimate of the direct cost of Section 271 prices, however, the Commission will (in effect) be (a) granting BellSouth a higher rate of return on Section 271 elements than elements offered pursuant to Section

[34] *Payphone Order*, ¶ 23.

251, and (b) the Commission will eliminate any dispute (by BellSouth) as to whether the appropriate input assumptions have been used.[35]

* Second, I recommend that the Commission increase the overhead loading applied to the direct cost measure described above. As the Commission is aware, TELRIC studies apply relatively low allocations of "shared and common" (or overhead) costs in developing TELRIC prices because the goal of such prices is efficient entry and competition. Although the Commission should also be concerned that entry is successful under Section 271, it would be consistent with the common application of the "just and reasonable" rate standard to permit modestly higher overhead loadings on Section 271 network elements than have traditionally been applied to Section 251 elements under TELRIC.

By recommending the above modifications, however, I do not want to suggest that I am endorsing the input assumptions proposed by BellSouth in Docket No. 14361-U, or that I believe that the overhead loadings adopted by the Commission for the development of Section 251 prices are in any way inadequate. To the contrary, the modifications that I propose above are inefficiently high, will retard competition and result in higher prices for Georgia consumers than would

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[35] BellSouth has previously claimed that its loop model reflects BellSouth's actual network routing choices and engineering rules:

> The BSTLM development team recognized that a major deficiency in the existing proxy models exists in that they unsuccessfully capture the *realistic routing that occurs between points in actual telecommunications networks*. BSTLM represents the implementation of the next generation of model routing. *It combines the aspects of the MST with the knowledge of roads and the rights-of-way that the telecommunications network will typically route over.* This approach is referred to in the documentation (and in the rest of my testimony) as the Minimum Spanning Road Tree ("MSRT"). *This is a breakthrough approach in that it "builds" the minimum amount of plant that connects points following the road network.*

Direct Testimony of Mr. James W. Stegeman on behalf of BellSouth Telecommunications, Inc., Before the Georgia Public Service Commission, Docket No. 14361-U, October 1, 2001, pp. 23-24. Emphasis added.

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otherwise occur if Section 271 UNEs are priced at TELRIC.[36] The fact is, however, that the "just and reasonable" standard is consistent with reasonably higher overhead loadings and, for these initial Section 271 prices, it is reasonable for the Commission to adopt higher rates. Specific recurring rate recommendations are presented in the following section.

Q. How should the Commission establish the non-recurring charges for Section 271 network elements?

A. I recommend that the Commission establish the non-recurring rates for Section 271 network elements at the levels as (would) apply to Section 251 network elements. As I explained earlier, the TELRIC-compliant rates for Section 251 network elements themselves satisfy the "just and reasonable" rate standard.[37] Consequently, there is no question that adopting the TELRIC-compliant non-recurring rate elements satisfies the pricing standard for Section 271.

More importantly, non-recurring charges are assessed whenever the status-quo is disrupted – that is, whenever a customer desires to change its service provider or change its service configuration. Such activities will always disproportionally affect competitors do not enjoy an existing base of customers that they inherited

[36] Indeed, the benefit to Georgia consumers would be even greater if the Commission established rates at TSLRIC, which BellSouth acknowledges are compensatory.

[37] Even though Section 271 prices are not *required* to be priced at TELRIC, there is nothing that *prohibits* establishing selected rate elements at their TELRIC level.

from a monopoly past. The recurring rates proposed in the following section amply compensate BellSouth each and every month that the customer and/or new configuration is in service at prices that are significantly above TELRIC – there is no need (or rational gain) to erect an additional barrier to customers having the opportunity to change providers or initiate new services. Because the competitive harm – and the harm to Georgia consumers – is exacerbated by inefficiently high non-recurring charges, there is no reason to further inflate BellSouth's Section 271 rates beyond the levels recommended in the following section.

III. Specific Just and Reasonable Rate Proposals

Q. Please summarize the recommendations contained in this section of your testimony.

A. In this section of my testimony I propose specific recurring rates for Section 271 network elements that may no longer be required under Section 251: High Capacity Loops, DS1 and DS3 Interoffice Transport and Local Switching.[38] In addition, the testimony also recommends a simplified flat-rate structure for local

[38] I am not proposing higher prices for shared transport because in the vast majority of routes, CLECs remain impaired without access to transport facilities. Moreover, the higher rate for Section 271 local switching proposed here generously compensates BellSouth for those instances where CLECs use shared transport (which is only used in conjunction with local switching). Consequently, while the entire increase is limited to the local switching element, the practical effect is higher rates

switching that has been adopted by the FCC (in the context of establishing a TELRIC-based rate) and the Tennessee Regulatory Authority (in adopting interim just and reasonable rates).

Q. Does your testimony address every potential Section 271 rate element?

A. No. CompSouth appreciates that the Commission is attempting to address critical market needs in an accelerated time frame. CompSouth has neither the time nor the inclination to present the Commission with difficult choices for elements that are not today important. The rates we propose below generously compensate BellSouth and we have narrowed the list of potential Section 271 network elements to only those elements that carriers need and use today.[39]

Q. Do the rates you propose below provide an "above-TELRIC" contribution to BellSouth's overhead costs?

[39] Section 271 embodies a comprehensive suite of obligations under generic description such as "loops, switching and transport" that include higher capacity loops (for instance, an OC-3) than those discussed below and more complex switching arrangements (such as PBX ports). Although there may be requests in the future for such elements – and the appropriateness of such requests may be judged on the basis of the cost and market conditions that then exist – local competition does not today depend upon their immediate availability at just and reasonable prices. To simplify the Commission's immediate task, CompSouth has restricted its list of Section 271 elements to only the most important elements that require pricing immediately. As such, our list of network element prices should not be interpreted as limiting future requests, but is rather deliberately narrow to reflect our pragmatic approach.

A. Yes. In addition to adopting BellSouth's own model results as the estimate of direct cost (which eliminates disputes concerning appropriate input assumptions and increases BellSouth's return by 15% to 11.25%), we have also increased the contribution to shared/common/overhead costs to 20% (an increase of approximately 33% above the level of contribution to shared/common/overhead costs that BellSouth proposed in its TELRIC prices).[40] As a result, the prices we recommend are *substantially* above TERLIC, but are still reasonably based on direct costs plus a just and reasonable contribution to overhead.

A. Loops

Q. What are the just and reasonable rates that you propose for Section 271 loop elements at issue in this proceeding (DS1 and DS3 loops) and associated multiplexing and cross connect systems?

[40] In the BellSouth Cost Calculation in Georgia Docket No. 14361-U, BellSouth utilizes a single Common Cost factor across all elements. However, different asset classes receive different Shared Cost factors. To derive the average Shared plus Common cost factor for a particular element, the proposed price was divided by its direct cost. BellSouth's Shared and Common cost factors average approximately 15 percent. As such, the shared/common/overhead factor used to develop CompSouth's proposed Section 271 rates of 20 percent represents a 33 percent increase over the Shared and Common costs that BellSouth sought to incorporate in its rates in its proposed UNE rates for Georgia.

A. The rates that CompSouth recommends for Section 271 local loop elements in those wire centers where such facilities are no longer available at TELRIC under Section 251 are as follows:

Loop Network Elements	TELRIC	CompSouth §271	Increase
Local Loops			
4-Wire DS1 Digital Loop - Zone 1	$49.41	$85.97	74%
4-Wire DS1 Digital Loop - Zone 2	$52.55	$81.27	55%
4-Wire DS1 Digital Loop - Zone 3	$68.40	$128.28	88%
High Capacity DS3 Loop – Facility Termination	$258.44	$323.53	25%
High Capacity DS3 Loop - Per Mile	$11.40	$13.47	18%
Multiplexing			
Channelization - Channel System DS3 to DS1	$124.39	$157.48	27%
Interface Unit - Interface DS3 to DS1	$7.50	$9.50	27%

B. Transport

Q. What are the rates that CompSouth recommends for the transport elements that BellSouth must continue to offer under Section 271?

A. The table below summarizes CompSouth's proposed Section 271 rates as compared to BellSouth's TELRIC-based rates required by Section 251. The increase in above TELRIC is somewhat less than for loops (above), largely because the effect of Commission adjustments to BellSouth's proposed transport rates was less. As with all the rates proposed by CompSouth, however, these rates are based on BellSouth's proposed rates, with an increase in the level of contribution.

Transport Network Element	TELRIC	CompSouth Proposed §271	Increase
DS1			
Termination	$34.93	$44.04	26%
Per Mile	$0.1199	$0.1417	18%
DS3			
Termination	$349.42	$440.53	26%
Per Mile	$2.63	$3.11	18%

C. Local Switching

Q. In addition to proposing higher Section 271 rates for local switching, do you also recommend a more efficient rate structure for this element?

A. Yes. I recommend that the Commission follow the lead of the FCC (and several other state commissions, including the Tennessee Regulatory Authority[41]) and adopt a simplified flat-rate structure for local switching. Specifically, I recommend the Commission adopt a flat-rate per analog switch port, inclusive of usage and features.[42] Such a simplified rate structure eliminates the need for call detail records and reflects the fact that modern circuit switches are port (and not usage) constrained.

[41] *Final Order of Arbitration Award*, Docket No. 03-00119, Tennessee Regulatory Authority (rel. Oct. 20, 2005).

[42] This rate would substitute for the following rate elements used by BellSouth to recover central office switching costs under section 251-based rates: port, features, end-office switching (usage) and shared trunk port charges (usage).

Over the past several years, several states and the FCC (in its role conducting the "Virginia Arbitrations")[43] have carefully examined whether a flat-rate structure is most appropriate for local switching. States that have adopted a flat-rate structure for unbundled local switching include Illinois,[44] Minnesota,[45] Indiana,[46] Wisconsin and Utah.[47] The FCC reached the same conclusion in resolving arbitrations involving MCI and AT&T (with Verizon) for Virginia. As the FCC explained:

> Given the record evidence that modern switches typically have large amounts of excess central processor and memory capacity, the usage by any one subscriber or group of subscribers is not expected to press so hard on processor or memory capacity at any one time as to cause call blockage, or a need for additional capacity to avoid such blockage.... Principles of cost causation, therefore, support a per line port cost recovery approach because, more than any other approach, it spreads getting started costs to carriers in a manner that treats equally all subscribers served by a switch.[48]

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[43] *Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration,* Memorandum Opinion and Order, 18 FCC Rcd 17,722 (2003).

[44] *Second Interim Order*, ICC Docket 96-0486 and 96-0569 Consolidated, Illinois Commerce Commission (Feb. 17, 1998) and *Order*, Illinois Commerce Commission Docket 98-0396 (July 10, 2002).

[45] *Order Setting Prices and Establishing Procedural Schedule*, MPUC Docket Nos. P-421/CI-01-1375, *et al.* (Oct. 2, 2002).

[46] *In the Matter of the Commission Investigation and Generic Proceeding on Ameritech Indiana's Rates for Interconnection Service, Unbundled Elements, and Transport and Termination Under the Telecommunications Act of 1996 and Related Indiana Statutes,* Indiana Utility Regulatory Commission, Cause No. 40611-S1, Phase I at 42 (Mar. 28, 2002).

[47] *Report and Order*, Utah PSC Docket No. 01-049-85 (May 5, 2003).

[48] *Virginia Arbitration Order* ¶ 463.

In addition, the FCC concluded that a flat rate "...approach avoids the competitive disadvantages associated with use of a per MOU price imposed on all usage and it avoids the problems involved with estimating the minutes of use over which to spread an estimate of switching costs."[49]

The presence of excess switching capacity reinforces the fact that a flat-rate structure is more cost-justified than alternative rate structures. As the Commission is aware, incumbent local exchange carriers have seen declining switched access lines over the past several years as customers have eliminated fax lines, second lines and even some primary line services. The number of BellSouth's switched access lines in Georgia -- and, therefore, available capacity on its switches -- has declined by more than 25% since 2000.[50] With switches *designed* with excess capacity -- and with the number of lines *declining* through time -- there is no justification for assuming that changes in usage will result in changes in switch costs, which is the economic basis for a usage sensitive switching rate.[51] The Commission should adopt a flat-rate structure for Section 271 local switching.

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49 Id., ¶ 483.

50 Source: ARMIS 43-08.

51 BellSouth's existing switching systems have already been designed and installed to serve the maximum peak capacity in an environment where BellSouth was a monopoly and there was underlying growth in access lines and usage. Because the number of lines and the usage on those lines is declining as customers shift to other providers and other services (for instance, Internet usage is shifting to DSL), BellSouth's existing switches should be entering a period of systematic excess supply. As such, there is no reasoned basis for recovering a portion of switching costs through usage-based charges.

Q. What is the flat rate that you recommend the Commission adopt in Georgia?

A. Applying the same methodology as was applied to loops and transport above (i.e., starting with BellSouth's inflated cost estimates from Docket No. 14361-U and increasing the overhead loading to 20%) produces a flat-rate per analog switch port of $6.86 per month.[52] This is extraordinarily high proposed rate for this element, particularly in comparison with similar flat-rate charges set by other commissions as the table below demonstrates, including the above-TELRIC just and reasonable rate set by the Tennessee Regulatory Authority.[53]

Comparison of CompSouth §271 GA Rate to Other States/FCC

State	Cost Measure	Rate	Proposed §271 Rate	% Above Comparable
Illinois	TELRIC	$2.18	$6.86	215%
Indiana	TELRIC	$2.98	$6.86	130%
Wisconsin	TELRIC	$2.83	$6.86	142%
Utah	TELRIC	$3.55	$6.86	93%
Minnesota	TELRIC	$3.12	$6.86	120%
Virginia (FCC)	TELRIC	$2.83	$6.86	142%
Tennessee	Just and Reasonable	$5.08	$6.86	35%

52 This recommended rate is based on an average usage per line from the 2002 ARMIS 43-04 Dial Equipment Minutes, which is the last year the FCC required BellSouth to file such information. Because of the substantial deployment of DSL that has replaced dial-up minutes since that time, it is likely that this estimate substantial overstates average usage today. I am continuing to investigate whether an alternative usage estimate is available, or whether SCIS can be modified to directly calculate a flat-rate switching charge and may modify this rate proposal prior to (or at) the hearing.

53 Significantly, local switches are purchased under national contracts from a limited number of vendors. As such, the cost per line should be reasonably close throughout the country, which is confirmed by the relatively narrow range of flat-rate local switching charges set by the various state commissions and FCC.

Moreover, the Section 271 rate that I am tentatively proposing here is nearly 65% above the average TELRIC rate established by the Georgia Commission ($4.18), a rate that is itself substantially higher than any of the flat-rate TELRIC rates established by any other state or the FCC. As indicated, I continue to investigate whether a more accurate application of the CompSouth methodology can be developed and may refine the proposed rate prior to hearing.

IV. Responding to BellSouth's Expected Claim (*TRO* ¶664)

Q. In the discussion above, you explain that the "<u>basic</u> just, reasonable, and nondiscriminatory rate standard ... that has <u>historically been applied</u>" requires that the Commission establish Section 271 network element prices that bear a reasonable nexus to cost. What arguments do you expect BellSouth to raise against this proposition?

A. Based on BellSouth's arguments to date, it appears that BellSouth's principal claim is that the "just and reasonable" standard is specifically set forth – and, importantly, limited by – the discussion by the FCC in ¶664 of the *TRO* that states:

> We note, however, that for a given purchasing carrier, a BOC <u>might</u> satisfy this standard by demonstrating that the rate for a section 271 network element is at or below the rate at which the BOC offers comparable functions to similarly situated purchasing carriers under its interstate access tariff, to the extent such analogues exist. Alternatively, a BOC <u>might</u> demonstrate that the

> rate at which it offers a section 271 network element is reasonable by showing that it has entered into arms-length agreements with other, similarly situated purchasing carriers to provide the element at that rate.[54]

In BellSouth's view, ¶ 664 provides that: (a) for local switching, BellSouth need only prove that carriers have signed agreements which contain local switching, and (b) the FCC has determined that interstate special access is sufficient to satisfy BellSouth's Section 271 obligations for loops and transport.

A. BellSouth's "Commercial Offers" for Local Switching Are Not Proof of Just and Reasonable Rates

Q. In your view, has BellSouth reasonably interpreted the discussion in ¶664?

A. No. There are a number of reasons why BellSouth's sweeping claims regarding this paragraph are wrong. As a threshold point, I want to emphasize that there is nothing in ¶664 that suggests the FCC established a new and unique "just and reasonable standard" peculiar to Section 271 elements. To the contrary, the FCC was unambiguously clear that it was subjecting Section 271 elements to the "basic just, reasonable, and nondiscriminatory rate standard ... that has historically been applied" to all manner of service,[55] not something unique devised solely for Section 271. To the extent that ¶664 provides guidance, that guidance must be

[54] *TRO*, ¶ 664. Emphasis added.

[55] *TRO*, ¶ 663.

consistent with the prevailing application of the standard as a cost-based standard, not viewed in such a way that the guidance replaces the traditional standard with an alternative.

Q. Do you believe that ¶664 is consistent with your description of the "basic just and reasonable standard" as a standard which maintains a nexus between cost and price?

A. Yes, under the appropriate conditions. To begin, it is important to recognize that the discussion in ¶664 is quite clear that it is only what an incumbent *might* be able to provide to justify the "just and reasonable" pricing standard. If there is sufficient competition to expect that market forces will force prices to cost – and that is exactly what competition is expected to do – then the presence of adequate competition *might* be sufficient to determine that rates satisfy the just and reasonable standard.

The mere fact that competition might be sufficient for a finding of just and reasonable, however, does not mean, as BellSouth claims, that it may charge "what the market will bear" under the assertion that competition exists. The important point is that ¶664 simply *observes* that there may be conditions where a competitive showing could demonstrate the likelihood of cost-based prices, but such a view reinforces the fact that the "just and reasonable" standard demands a nexus to cost, rather than abandoning the standard as BellSouth claims.[56]

Q. Does the requirement that any contracts be "arms-length" further indicate that competition must be present in the market before BellSouth may claim that signed agreements are sufficient to prove that its rates are just and reasonable?

A. Yes. There are times when an "arm's length" transaction can provide the basis for a fair market valuation. However, the conditions necessary for such contracts to be considered arm's length include the existence of willing buyers and sellers, neither with a compulsion to buy or to sell, each having reasonable knowledge of the facts, and competition with other similar options. In other words, market conditions might justify using a market price as a proxy for cost, but there would still need to be a finding that sufficient competition exists for the Commission to be confident that market forces are, indeed, sufficiently active to force prices to cost.

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[56] As an aside, in my experience, the FCC is usually more definitive when adopting major shifts in policy, and seldom begins such pronouncements with "we note" and condition their reasoning with "might."

Q. BellSouth will claim that the FCC has already decided that the market for local switching is competitive when it determined that CLECs were not impaired. Is such a claim accurate?

A. No. The FCC has been quite clear that the requirements of Sections 271 and 251 are independent. There is nothing in FCC orders that suggests that a finding of non-impairment is equivalent to a finding that sufficient competition exists that would ensure that Section 271 prices are just and reasonable. To the contrary, when deciding to relieve Qwest of certain unbundling obligations in the Omaha LATA, the FCC was quite specific that it was retaining Qwest's obligations under Section 271 for, among other reasons, the fact that the FCC's non-impairment findings were *deliberately* over-broad:

> When the Commission established its impairment determinations, it did so at a level designed to provide incentives for self-provisioning competitive facilities, rather than based on a finding that in all cases self-provisioning of competitive facilities is economically feasible. As a result, the Commission's impairment determinations necessarily sometimes are under-inclusive. In other words, it sometimes is not feasible for a reasonably efficient competitive carrier economically to construct all of the facilities necessary to provide a telecommunications service to a particular customer despite not being impaired under the Commission's rules without access to such facilities.[57]

[57] *Memorandum Opinion and Order,* Federal Communications Commission WC Docket No. 04-223, September 16, 2005, Released December 2, 2005 ("*Omaha Forbearance Order*"), ¶104. (Footnotes omitted).

Q. To your knowledge, has BellSouth ever offered <u>any</u> evidence that would demonstrate that its price for Section 271 local switching is being constrained by a competitive market?

A. No. As recently as last month, BellSouth informed the FCC that it was unaware of any competitive providers of local switching that actually provided service or where such services are being provided:

> Because BellSouth is not a purchaser of wholesale switching, BellSouth does not have possession of any information that provides BellSouth with first-hand knowledge of whether the CLECs [named by BellSouth]… are actually providing switching to third parties. While a number of the CLECs … have websites that indicate those CLECs have a wholesale switching offering, BellSouth has no information in its possession to confirm or deny whether such wholesale switching is actually being provided to a third party in those geographic areas…. BellSouth is in no position to obtain, and has no first-hand information of, the geographic reach of the each of the CLEC switches [listed by BellSouth].[58]

It is inconceivable that BellSouth would be "competing" in a market for local switching – and, therefore, be price constrained by other competitors – yet be unable to provide any market information to the FCC as to who its competitors were, what prices they were charging, or where they offered service. It is not enough to satisfy ¶664 by merely *claiming* there is price-constraining competition; if BellSouth hopes to rely on that approach to demonstrate that its rates are just and reasonable, it must show real alternatives and competitive

[58] BellSouth Notice of Filing, Federal Communications Commission File No. EB-05-MD-029, December 12, 2005.

pricing. The fact that BellSouth has signed agreements with a number of carriers does not mean that its rates are reasonable – after all, if there are no alternatives, BellSouth should be expected to sign most carriers, albeit charging monopoly rates.

Q. What would we expect if BellSouth had market – indeed, monopoly – power in the pricing of local switching?

A. Significantly, if BellSouth is the only provider of local switching in a market (which is what the evidence shows), then the Commission should expect that BellSouth would be able to execute a large number of contracts, covering most of the lines in Georgia. That is exactly the outcome that would be expected if BellSouth had market power. Consequently, the Commission cannot merely *count* contracts -- it must look beyond the mere existence of agreements to determine whether the rates are just and reasonable.

If BellSouth enjoyed market power, the indicia of that market power would be high rates (i.e., rates unreasonably above cost) and declining volumes. The fundamental purpose of regulation is to prevent a firm from exercising market power by charging high rates that depress demand (quantity). The Commission must look at the relationship of price to cost and what is happening to volume under those agreements.

Q. Is the data consistent with BellSouth enjoying market power and pricing at excessive levels?

A. Yes. The rate that BellSouth is charging is clearly excessive. Based on the same average usage assumption used above (to calculate flat-rates), BellSouth's commercial offer rate (which is $7 above TELRIC) is $11.18 per month, which is 295% above TELRIC (as defined by the FCC) and 167% above TELRIC (as set by this Commission). Such pricing is clearly an indicator of market power – and market abuse.[59]

Moreover, it is useful to consider the *pattern* of BellSouth's price changes in its so-called commercial agreements. The following market trends should not be in dispute. First, the utilization of BellSouth's switches is declining today and can be expected to decline in the future. Second, the addressable market for CLECs seeking to use BellSouth's local switches – essentially customers desiring lower capacity analog phone services – is expected to decline as more customers shift to broadband offerings. And third, whatever alternatives to BellSouth's switches do exist (and BellSouth cannot point to any credible examples of wholesale offerings

[59] In comparison, a study conducted by the United Kingdom's National Criminal Intelligence Service recently concluded that a Afghan heroin trafficker's average profit margin is only 58%, which, while higher than Louis Vuitton (48%) or Gucci (30%), pales in comparison to BellSouth. *Revealed: How Drug Wars Failed.* The Guardian, July 5, 2005.